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## BEFORE THE ARIZONA CORPORATION COMMISSION

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2009 AUG -7 P 1:18

AZ CORP COMMISSION  
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IN THE MATTER OF THE APPLICATION OF  
SUNRISE WATER COMPANY FOR A  
DETERMINATION OF THE CURRENT FAIR  
VALUE OF ITS UTILITY PROPERTY AND  
FOR AN INCREASE IN ITS WATER RATES  
AND CHARGES.

DOCKET NO. W-02069A-08-0406

**STAFF'S REPLY BRIEF****I. INTRODUCTION.**

Arizona Corporation Commission Staff ("Staff") agrees with Sunrise Water Company ("Sunrise") that the parties have been able to substantially narrow the issues in this case. There are only a few issues remaining in dispute between Staff and Sunrise. These issues include: the treatment of post test year refunds of AIAC, the Normalization of Hydrant-Water Sales, Outside Services Expense, Barn, Workshop, Storage, Field Office, and Yard Rental Expense, Rate Case Expense, Income Tax Expense, and a few minor issues relating to Rate Design.

It is Sunrise that bears the burden of proof in this case, and on these issues, Sunrise has not met its burden. Therefore, the Commission should adopt Staff's recommendations on these issues as discussed below.

**II. RATE BASE – POST TEST YEAR REFUNDS OF AIAC.**

Sunrise chose a test year ending December 31, 2007. While it is not entirely clear, it appears Sunrise is seeking to reduce test year AIAC, by post test year refunds, totaling \$64,178.<sup>1</sup> Sunrise asserts that this amount represents the portion of the refunds that is attributable to the revenue received during the test year.<sup>2</sup> There are essentially two prongs to the Company's argument for the inclusion of the AIAC refunds. First, the Company claims that the August 2008 refund payment was required by Commission rules and was based on revenues generated during the period July 1, 2007,

<sup>1</sup> Ex. A-6 at 5.

<sup>2</sup> *Id.*

1 through June 30, 2008.<sup>3</sup> Sunrise asserts that because of test-year revenues, it was required to make  
2 refund payments in 2008, and because the refund obligation accrued during the test year, the known-  
3 and-measurable refund amount should be included as reduction in test year AIAC.<sup>4</sup>

4 The Company's argument is flawed. The Company has not set forth any Commission rule  
5 that permits the reduction of test year AIAC by post test year refunds. Further, it is important to  
6 remember that in Arizona, ratemaking is based on a historic test year, which requires the matching of  
7 investments, revenues and expense at the end of the test year.<sup>5</sup> The treatment that the Company is  
8 seeking in this matter is in contravention of this ratemaking principle. In addition, the Company's  
9 recommendation equates to single issue ratemaking and in essence requires the ratepayers to provide  
10 a return on non-investor capital.<sup>6</sup> The Company acknowledges that even the portion of the refunds  
11 that had accrued during the test year were not recorded on the books during the test year, and, in fact,  
12 were not disbursed and recorded until eight months after the end of the test year.<sup>7</sup> The end result is  
13 the Company's proposal understates AIAC and overstates rate base by \$64,178.<sup>8</sup>

14 Second, the Company also cites Docket No. WS-1303A-06-0403, Arizona-American Water  
15 Company, as an example of where Staff recommended, and the Commission approved the reduction  
16 of test year AIAC by refunds of AIAC. However, the Commission's Decision in that case has no  
17 application here. The Commission's decisions do not have any precedential effect. Each case before  
18 the Commission stands on its own, based on the unique facts and circumstances that exist. Also, the  
19 AIAC refunds in question were paid during the test year. In this case Sunrise is seeking to include  
20 post test year refunds of AIAC. Staff continues to recommend the recognition of post test year  
21 refunds of AIAC in rate base.

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26 <sup>3</sup> Sunrise's Post-Hearing Brief at 2.

27 <sup>4</sup> *Id.*

28 <sup>5</sup> Ex. S-2 at 14.

<sup>6</sup> Tr. 76, Ex. S-2 at 14.

<sup>7</sup> Tr. 100-101.

<sup>8</sup> Ex. S-3 at 3.

1     **III.     INCOME STATEMENT ADJUSTMENTS.**

2             **A.     The Commission Should Adopt Staff's Method of Normalizing Hydrant-Water**  
3             **Sales.**

4             Staff and the Company agree that the hydrant-water sales should be normalized. However,  
5     the parties continue to disagree regarding the appropriate methodology. It is clear that the Company's  
6     methodology, if adopted, will have the effect of understating test year revenues, and ultimately  
7     overstating the revenue requirement.<sup>9</sup> First, the Company's method averages sales over a five year  
8     period. This by itself will have the effect of reducing test year revenues, because the Company is also  
9     seeking to include one year of low sales. This will further dilute hydrant-water sales revenue. In  
10    another attempt to bolster its revenue requirement, Sunrise wants to exclude sales from the Flood  
11    Control project.<sup>10</sup> The Company claims these sales are non-recurring and should not be included in  
12    the normalized level of hydrant-water sales.<sup>11</sup> However, the Company does not dispute that its  
13    overall hydrant-water sales have been trending upward from 2003 through 2008.<sup>12</sup> In fact, the  
14    Company could not articulate what other projects that took place during the representative period  
15    were not recurring.<sup>13</sup> It is plausible that the Company's methodology is to only include the largest  
16    projects within its territory, as an outlier, simply to magnify the dramatic effect it has on reducing the  
17    normalized hydrant-water sales.

18            It is important to remember that 1983 was the last time that the Sunrise filed an application  
19    with the Commission for a rate increase. The Company is speculating that there won't be an increase  
20    in hydrant-water sales in the foreseeable future.<sup>14</sup> The risk that exists, if the Commission adopts the  
21    Company's methodology, is that hydrant-sales increase, the Company does not file for another rate  
22    case, and as a result is over-earning.<sup>15</sup> However under Staff's recommendation, this potential is  
23    lessened. If the hydrant-water sales do in fact decrease, contrary to the apparent trend, the Company

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<sup>9</sup> Tr. 150.

26            <sup>10</sup> Ex. A-6 at 9.

27            <sup>11</sup> Post-Hearing Brief at 4.

28            <sup>12</sup> Tr. 25.

<sup>13</sup> *Id.*

<sup>14</sup> Tr. 47.

<sup>15</sup> *Id.*

1 can simply file another, more timely, application with the Commission. Staff continues to  
2 recommend an adjustment of \$33,435 for normalized hydrant-water sales.<sup>16</sup>

3 **B. The Commission Should Disallow the Company's Outside Services Expense.**

4 The Company claims that SRW Consulting assisted with regulatory compliance by providing  
5 regulatory and legislative monitoring and reporting services, helped develop communication  
6 strategies and managed issues encountered at State regulatory agencies.<sup>17</sup> There are several points to  
7 remember. First, Sunrise only has approximately 1300 customers. Second, the Company has not  
8 been in for a rate case since 1983, so it is unclear what sort of assistance the Company would need  
9 from SRW Consulting. Third, the Company acknowledges that SRW Consulting at least in part does  
10 provide lobbying services.<sup>18</sup> Finally, and perhaps most telling, the Company is not aware of any other  
11 similarly sized company that has a consulting firm on retainer.<sup>19</sup> It is Staff's position that the expense  
12 of \$13,500 for SRW Consulting services is unnecessary, was incurred at the discretion of  
13 management, does not provide a benefit to ratepayers, and should therefore be disallowed.

14 **C. The Company's Rent Expense Should be Disallowed.**

15 The Company is seeking to include rent expense of \$37,595 for its use of a barn, workshop,  
16 storage, field office, and yard, which are owned by Mr. Campbell, into rate base.<sup>20</sup> The Company  
17 claims that it is undisputed that a water utility must use these types of facilities. Staff does not agree  
18 that these facilities are necessary for the provision of service.<sup>21</sup> Additionally, there are several  
19 problematic issues concerning the Company's rent expense.

20 First, it is undisputed that Mr. Campbell, the sole shareholder of Sunrise, and is also the owner  
21 of the facilities that the Company is renting. The potential problem for self dealing exists where the  
22 owner of the utility is also the owner of the facilities that the company is renting. Even the Company  
23 acknowledges this potential.<sup>22</sup> Second, the Company was not able to produce any written agreements  
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<sup>16</sup> Ex. A-3, Schedule AII-4.

26 <sup>17</sup> Post-Hearing Brief at 7.

27 <sup>18</sup> Tr. 45.

28 <sup>19</sup> Tr. 46.

<sup>20</sup> Post-Hearing Brief at 8.

<sup>21</sup> Ex. S-2 at 30.

<sup>22</sup> Tr. 105-106.

1 between the Company and Mr. Campbell for the lease of facilities.<sup>23</sup> In fact, the Company was not  
2 able to describe with any great certainty how the lease amounts were determined. The Company  
3 claims the rate was determined during its last rate case in 1983, and that subsequently it has been  
4 automatically adjusted annually to account for inflation.<sup>24</sup>

5 Given the number of customers that Sunrise has, Staff does not believe these facilities are  
6 necessary for the provision of service. However, Staff believes that the Well No. 7 site, which is  
7 already included in rates, would provide the Company with sufficient room for storage. The  
8 Company claims that using this site would require it to obtain a special use permit and spend at least  
9 \$150,000 to replace the existing facilities. However, the Company did not provide any  
10 documentation to support that dollar amount. If the Commission determines these facilities are  
11 necessary, Staff recommends that the Company should explore the use of the Well No. 7 site. In the  
12 alternative, the Company should enter into written lease agreements based on current market values.

13 To further its argument, the Company cites to the West End Water Co. ("West End") rate case,  
14 Decision No. 68925. The Company asserts that since the Commission included in rate base a portion  
15 of the rental expense, for similar facilities, in the West End Water Co. case, that the Commission  
16 should, likewise, include Sunrise's rental expense in rate base.<sup>25</sup> However, even the Company  
17 acknowledges that in the West End matter, there was no hearing and the issues may not have been  
18 developed since the administrative law judge didn't have the opportunity to ask questions.<sup>26</sup> Further,  
19 the Commission's decisions do not establish precedent.

20 **D. The Commission Should Disallow \$15,000 of the Company's Rate Case Expense.**

21 The Company is requesting \$90,000 in rate case expense or a normalized amount of  
22 \$30,000.<sup>27</sup> Staff takes issue with this amount of rate case expense for several reasons. First, it is  
23 important to keep in mind that Sunrise only has approximately 1,300 customers. Second, the  
24 Company was initially seeking recovery of \$75,000, and waited until rejoinder testimony to update  
25 this amount to \$90,000 even while acknowledging that there were no new issues introduced during

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26 <sup>23</sup> Tr. 43.

27 <sup>24</sup> Tr. 43-44.

<sup>25</sup> Post-Hearing Brief at 12.

28 <sup>26</sup> Tr. 52-54.

<sup>27</sup> Post-Hearing Brief at 12.

1 this case.<sup>28</sup> Third, the Company admits that it knew all of the issues that were contested in this matter  
2 once Staff filed its direct testimony, but did not update the amount of rate case expense it was seeking  
3 at that time.<sup>29</sup> Finally, and most importantly, the Company admits that it only expended  
4 approximately \$64,500 in rate case expense in its rejoinder testimony. This left a balance of  
5 approximately \$10,500 of its original estimate to complete the hearing, prepare closing briefs, and  
6 attend the Open Meeting. Staff believes this balance should be sufficient to see this case through to  
7 completion.<sup>30</sup> Given the issues in this case, the size of the Company, and the Company's original  
8 estimate of rate case expense, Staff continues to recommend the inclusion of \$75,000 in rate case  
9 expense.

10 **E. The Inclusion of Income-Tax Expense Creates a Fiction.**

11 Staff is not entirely clear on the amount of income tax expense the Company is seeking to  
12 include. However, what is clear is that the Company is seeking to include income tax expense when  
13 it does not actually pay any income tax. Sunrise is a Subchapter S Corporation. What this means is  
14 that the operating income is distributed to the shareholders and taxed as ordinary income to the  
15 shareholders. In this case, Mr. Campbell is the sole shareholder of the Company.

16 The central point here is that Mr. Campbell, as the sole shareholder and president of the  
17 Company, made the election to be taxed in this manner, and could similarly make an election to be  
18 taxed as a C-Corporation. The Company claims Staff's position is "discriminatory and unfair"  
19 because it disallows any income tax expense for S-Corporations ("S-Corp") and Limited Liability  
20 Companies ("LLC"). The Company appears to base this allegation on three factors. First, the  
21 Company asserts "that the Commission allows recovery of tax expense for C-Corps like APS, Tucson  
22 Electric Power, and Southwest Gas, even though these entities do not pay taxes directly, but just like  
23 an LLC or S-Corp pass through tax expense to the ultimate shareholders."<sup>31</sup> The key distinction is  
24 that these entities are C-Corporation, and, but for the fact that they are part of a consolidated group,  
25 they would pay income tax. This is not the case with Sunrise.

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27 <sup>28</sup> Tr. 91-92; Post-Hearing Brief at 12.

28 <sup>29</sup> Tr. 92.

<sup>30</sup> Tr. 163-164.

<sup>31</sup> Post-Hearing Brief at 13.

1 In its attempt to recover income tax expense, that it does not pay, Sunrise is asking the  
2 Corporation Commission to treat this S-Corp differently. In other words, the Company is attempting  
3 to create a correlation between C-Corps that are part of a consolidated group, and the treatment they  
4 receive for income tax expense, and an S-Corp where no correlation exists.

5 Second, the Company argues other jurisdictions, such as New Mexico, have allowed the  
6 recovery of income tax expense. Since the Arizona Corporation Commission uses a hypothetical  
7 income tax calculation for consolidated C-Corps, the Arizona Commission has effectively agreed  
8 with the treatment in New Mexico.<sup>32</sup> This is an absurd argument.

9 The New Mexico case the Company cites carries no legal weight in Arizona. In addition, the  
10 Court in the *Consolidated Water Utilities v. Ariz. Corp. Comm'n* case made it clear that it is up to the  
11 Arizona Corporation Commission to allow or disallow income tax expense. 178 Ariz. 478, 875 P.2d  
12 137 (1993). The Arizona Corporation Commission has been consistent in disallowing the inclusion of  
13 income tax expense in cases involving S-Corps and LLCs.<sup>33</sup> The only case the Company has cited  
14 where the Commission allowed the recovery of income tax expense by an S-Corporation is the 1997  
15 Camp Verde Water Systems, Inc. case, Decision No. 60105.

16 While the Commission did allow Camp Verde Water Systems, Inc. to recover income tax, it  
17 was based on the special circumstances that existed in that case. In particular, at the hearing the  
18 Company indicated that the bank would not loan the Company money unless the rates approved  
19 provided for income taxes.<sup>34</sup> Sunrise acknowledges that it did not present any unique circumstance  
20 that warrants the Commission allowing the income tax expense in this case.<sup>35</sup> Staff continues to  
21 recommend that the Commission disallow the inclusion of income tax expense.

#### 22 IV. RATE DESIGN.

23 Staff has consistently introduced tiered rate structures as a conservation measure. The  
24 Company's ratepayers have a high consumption pattern, with a median usage of 13,476, and an

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<sup>32</sup> *Id.*

26 <sup>33</sup> The Company cites to Fisher's landing water and Sewer Works, LLC, Winchester Water Company, LLC, and  
27 Wickenburg Ranch Water, LLC, as examples where the Commission has allowed LLCs to recover income tax  
28 expense. This error has been corrected in Fisher's Landing and Winchester Water, and Staff anticipates it will be  
corrected for Wickenburg Ranch in the future.

<sup>34</sup> Decision No. 60105.

<sup>35</sup> Tr. 300-301.

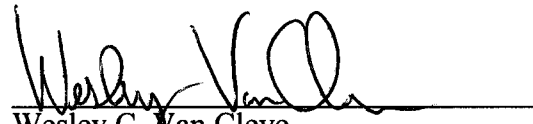
1 average consumption of 17,782.<sup>36</sup> The Company argues that “. . . [e]stablishing the break-over point  
2 at the average usage . . . sends proper conservation price signals to Sunrise customers without placing  
3 undue burden on below average usage.”<sup>37</sup> Both Staff and the Company are proposing a tiered rate  
4 structure. Prior to this case the Company had a single tier commodity rate.

5 It is Staff’s position that in making this conversion to a tiered rate structure, it is important to  
6 send the proper conservation price signal. The Company acknowledges that a lower break-over will  
7 promote more efficient use of water than a higher break-over point.<sup>38</sup> Staff continues to recommend a  
8 second break-over point of 13,000 gallons for 3/4 inch meter in order to encourage more efficient use  
9 of water.<sup>39</sup> Staff also continues to recommend a slightly lower meter installation and service line  
10 charge for the 2 inch meter (compound), and separate meter and service line charges.<sup>40</sup>

11 **V. CONCLUSION.**

12 Staff respectfully requests that the Commission adopt its recommendations on the disputed  
13 issues for the reasons stated above, in its Closing Brief, and the testimony Staff provided in this case.

14 RESPECTFULLY SUBMITTED this 7<sup>th</sup> day of August, 2009.

15  
16   
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25 . . .  
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27 <sup>36</sup> Ex. S-3 at 13.

<sup>37</sup> Post-Hearing Brief at 16.

<sup>38</sup> Tr. 93.

<sup>39</sup> Ex. S-3 at 13.

<sup>40</sup> Ex. S-1 at 12.

1 Copy of the foregoing mailed this  
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